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THE USES OF PENSION AND PROFIT-SHARING PLANS FOR SMALL OR MEDIUM-SIZED BUSINESSES

BY BARRY R. PERIL*

In recent years, there has been an enormous increase in the amount of public attention directed toward pension and profit-sharing plans. Although these plans have been in existence for many years, it has only been with the increased recognition given to the federal income and estate tax advantages of these plans under the Internal Revenue Code that their growth has accelerated at such a sharply increasing rate. Because of the incentives and the financial security they provide for employees, coupled with their income and estate tax advantages to employer and employee alike, pension and profit-sharing plans have become widely adopted throughout American industry. It is no longer the case that only the very largest corporations establish such plans. Instead, increasing numbers of medium and small-sized enterprises are considering and adopting such arrangements.

It is the purpose of this article to convey a summary of the characteristics and advantages of pension and profit-sharing plans. Obviously, within the scope provided by a single article, an exhaustive presentation of the subject cannot be attempted. Limitations of space and time preclude the discussion of certain problems and the further elaboration of others. However, those aspects of pension planning and profit sharing will be discussed which experience has indicated are the more important considerations for the businessman and his advisors who have the dual task of deciding whether or not to adopt such a plan, and if one is adopted, which type of plan will be best suited to the needs of the business and its employees.

The term "qualified plan" as used throughout this article has reference to a plan which meets all of the requirements established by the Internal Revenue Code of 1954 and regulations issued thereunder, so that it is eligible for the very considerable federal income and estate tax advantages granted to these plans.[1] Also, its meaning in all instances will be restricted

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1. INT. REV. CODE OF 1954, §§ 37 (retirement income credit), 101 (death benefit exclusion), 105 (disability payments exclusion), 401 through 404 (qualification, employer deductions, taxation of employees and beneficiaries), 501 (tax-exempt status of plan), 2039 (estate tax exemption), and 2517 (gift tax exemption).

Although these statutory provisions are very detailed and extensive in scope, this area of the tax law has received an enormous amount of administrative attention in the form of regulations, rulings, procedures and unwritten administrative practices, especially in the conferences and discussions preceding a ruling that a particular plan qualifies under the Code. In addition to the published Revenue Rulings, to be found to a "trusteed" plan;[2] the reason is that businessmen generally prefer diversity in investment of fund assets[3] (termed "split-funding"[4]), available only by use of a trust, which in turn relegates potentially "qualified" "non-trusteed" plans[5] to minor significance.

In the ensuing discussion, every effort will be utilized to present those aspects of qualified plans which are most appropriate to the medium or small-sized enterprise, rather than to consider the vast complex factors which very large plans present. No attempt will be made to enter into detailed and sophisticated actuarial discussions, but the emphasis throughout will be upon the more readily understood type of plan.

The Mechanics of a Qualified Plan

What is a pension or profit-sharing plan?[6] Generally, a plan requires the creation of a trust in the form of a trust indenture or agreement, under

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in the regularly issued Internal Revenue Bulletins and compiled annually in the Cumulative Bulletins, the Pension Trust Section of the Internal Revenue Service for many years issued an independent series of rulings, identified as "P.S. No.—." The issuance of these P.S. Rulings was discontinued in 1953. Rev. Rul. 2, 1953-1 CUM. BULL. 484. Subsequently, the Internal Revenue Service issued a comprehensive ruling summarizing the applicable rulings and procedures. Rev. Rul. 33, 1953-1 CUM. BULL. 267. In later years, this comprehensive ruling has been up-dated and revised in accordance with current developments and changes in the law. Rev. Rul. 57-163, 1957-1 CUM. BULL. 128 and Rev. Rul. 61-157, INT. REV. BULL. No. 1961-35.

2. INT. REV. CODE OF 1954, §§ 401, 404.

3. This is the author's own personal observation. Clearly, there are pros and cons on the various methods by which the funds of the plan may be invested, and one should not reject any method of funding without giving is serious consideration. For a discussion of the benefits of different funding methods, see DUNCAN AND CHAICE, TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION, ch. II (Prentice-Hall 1960).

4. Split-funding means a division of investment between annuity and insurance contracts on the one hand and different forms of investment on the other.

5. The most common example is the so-called group annuity plans, in which benefits are provided entirely by annuity contracts administered by an insurance company. Treas. Reg. § 1.404(a)-3(a).

6. INT. REV. CODE OF 1954, § 401 specifies three types of plans which qualify for exemption, namely stock bonus, pension and profit-sharing plans. Only the last two are discussed in this article. § 401 also describes the conditions which must be met in order to have a plan qualify. They are:

(1) Contributions must be made to the plan for the purpose of distributing to the covered employees or their beneficiaries the corpus and income accumulated by the trust in accordance with the provisions of the plan.
(2) Under the trust instrument, it must be impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of employees and their beneficiaries.
(3) The plan must cover either a stated percentage of the employees of the employer (discussed more fully *infra*, p. 153) or must cover such a classification of employees which the Internal Revenue Service deems not to be discriminatory in favor of employees who are officers, shareholders, supervisory employees, or highly paid employees.
(4) The contrtibutions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, supervisory or highly paid employees.

which trustees are designated to administer funds for the benefit of certain employees who fulfill the eligibility requirements for membership in the plan. The trustees may be any one or more persons, including the shareholder-executives of the business, an attorney, an accountant, an independent corporate fiduciary, such as a bank or trust company, or any other qualified person.[7] The terms of the trust may provide that any one or more of the trustees can be removed by the employer and replaced by such new trustees as the employer may select. The administration of the plan and its relationship to the employer are determined by the pension plan agreement or the profit-sharing plan agreement, as the case may be, which is a contract entered into by the trustees of the plan and the employer.

Each year the employer will contribute to the trustees an amount which will be held by the trustees and invested by them for the benefit of the employee beneficiaries. The amount contributed may be in the form of cash or other property.[8] After the contribution has been made, the cash or other property, and all of the earnings thereon, will become the property of the trustees. It is no longer subject to any control by the employer. The trustees then proceed to invest the money or other property received. The investment may take any form which the local state law permits.[9] Adequate provisions may be inserted in the trust instrument and in the plan agreement that would have the effect of not limiting the trustees to "legal" investments, but will permit the trustees to use their discretion to make any reasonable form of investment. Under such a provision, the trustees could invest in marketable securites, mortgages, real estate, tangible personal property, life

7. See Prentice-Hall, *Pension and Profit-Sharing*, ¶ 2042 for the advantages of using a corporate trustee.

8. Colorado National Bank of Denver, 30 T. C. 933 (1958). However, certain problems arise if contributions are made in the form of property other than cash. If the value of the property contributed exceeds its income tax basis, the Internal Revenue Service treats the transaction as the equivalent of a sale or exchange, resulting in a gain to the employer, which may be capital gain or ordinary income, depending on the nature of the property involved. I. T. 3357, 1940-1 CUM. BULL. 11. The Sixth Circuit has approved this position of the Internal Revenue Service, U.S. v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960). The justification for this position is that the employer obtains a tax deduction, based upon its contribution to the plan, equal to the fair market value of the property contributed, which is equivalent to the economic benefit derived from a sale or exchange. For other decisions which hold a gain is realized on dispositions other than by sale, see Commissioner v. Mesta, 123 F.2d 986 (3d Cir. 1941), involving a transfer of appreciated securities in a divorce settlement, and International Freighting Corp., Inc. v. Commissioner, 135 F.2d 310 (2d Cir. 1943), involving a transfer of appreciated securities by an employer as a bonus to certain employees.

On the other hand, if an employer contributes property which has a fair market value less than its basis, the employer cannot deduct the difference as a loss, since the transaction is one between related taxpayers, a grantor and a fiduciary of a trust created by the grantor, INT. REV. CODE OF 1954, § 267(b)(4). See also Rev. Rul. 61-163, 1961 INT. REV. BULL. No. 37.

9. Treas. Reg. § 401-1(b)(5).

insurance contracts, annuity contracts, and mutual funds, or in any combination of them. The amounts contributed by the employer, along with the earnings on these funds, are allocated by the trustees annually in accordance with the plan provisions to the respective accounts of each employee covered by the plan.[10]

An employee is entitled to receive the funds allocated to his account by the trustees upon the occurrence of several designated events, all or any number of which may be provided for by the plan.[11] Thus, when an employee reaches retirement age, which is generally age 65,[12] he may be entitled to all of the money allocated to his account or to receive a stated pension. Likewise, should an employee die before he attains retirement age, his beneficiaries[13] would receive the funds set aside in his account, or such life insurance benefits as the plan may provide or both. Furthermore, certain plans may make provision for distributions to be made to employees during any period of time in which they are wholly or partially disabled. In addition, under certain circumstances employees may obtain loans from the plan in order to meet any emergency needs which they might have.[14]

Whenever benefits are payable by the plan, such as at retirement or at death, they may be paid by the trustees to the employee or his beneficiary in one lump sum, in the form of an annuity over an employee's lifetime or a definite period of years, or in installments extending over a definite period

10. In a profit-sharing plan, funds held by the plan must be allocated to each participant in accordance with a definite formula. Rev. Rul. 61-157, 1961 INT. REV. BULL. 35, Pt. 2(t). This manner of allocation is not essential to pension plans, since the plan is intended to provide a definite benefit at retirement, death, or disability, rather than to set aside a specific sum annually for each employee, as is the case with profit sharing.

11. Treas. Reg. § 1.401-1(b)(1) states that a pension plan may provide benefits, in the form of distributions from the trust to the beneficiary, at such time as the employee-beneficiary retires, becomes disabled, or dies. A pension plan may not provide for benefits not customarily found in pension plans, such as sickness, accident, hospitalization or layoff benefits. This portion of the Regulations also provides, with respect to profit-sharing plans, that benefits may be payable to an employee or his beneficiary after the expiration of a fixed number of years, the attainment of a stated age, or upon the occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment.

12. While the normal retirement age is generally 65 years, it may be lower if employees customarily retire at an earlier age in the particular business of the particular employer. 1961 INT. REV. BULL. No. 35, Pt. 5(h). Also, the plan may provide for retirement of an employee before he attains retirement age, Rev. Rul. 61-157, 1961 INT. REV. BULL. No. 35, Pt. 5(i). However, if the consent of the employer is required before an employee can retire early under the plan, the value of the early retirement benefit may not exceed the value of the employee's vested benefits at that time.

13. A plan may provide that an employee may be free to designate any beneficiary he wants, or the employee may be restricted to the selection of specified persons who are the natural objects of his bounty or to his estate. Rev. Rul. 61-157, 1961 INT. REV. BULL. No. 35, Pt. 2(q).

14. Rev. Rul. 61-157, 1961 INT. REV. BULL. No. 35, Pt. 5(q).

of years. The trustees may have discretion as to which method may be used in disbursing these benefits.[15]

When an employee terminates his employment, he may or may not be entitled to receive the amount set aside in his account by the trustees depending upon the provisions of the plan. The term used to describe the amounts which the employee is entitled to in this event is called his "vested" interest or his "vested" rights. Thus, if an employee's account is 100 percent vested at such time as he leaves his employment with the employer, whether he has reached retirement age or not, he would be entitled to receive from the trustees the full amount set forth in his account. Accordingly, if his account is 50 percent vested, he can take only half the amount set aside in his account. The additional 50 percent to which he is not entitled would be redistributed, under profit sharing, for the benefit of the other employees remaining in the plan, and, under pension planning, would be utilized to reduce the contributions required by the employer in subsequent years.[16] Vesting is generally determined by a set formula, under which a certain percentage of the amount set aside in the employee's account is vested each year, until finally the account, after a series of years, becomes 100 percent vested. Thus, a typical example of a vesting provision might be for an employee to receive, after one year's participation in the plan, a 10 percent vested interest in the amount set aside in his account. At the end of each succeeding year, until the tenth year is reached, he will receive an additional 10 percent vesting, and at the end of the ten-year period, his account will be fully vested.[17] Thus, if at the end of a three-year period the amount set aside in the employee's account is 1,000 dollars and he is 30 percent vested, he would be entitled to receive 300 dollars from the trustees if he were to

15. Rev. Rul. 61-157, 1961 INT. REV. BULL. No. 35, Pt. 5(n). Although the provisions of the plan may give the Trustee discretion in selecting between modes of settlement for distributing these benefits, all of the permissible modes of settlement must have the same value. The amounts distributable to the employer or his beneficiary must be fully vested under all circumstances, and if periodic distributions are to be made to any one employee, the present value of these payments must be the actuarial equivalent of the lump sum distribution which would have been available to him had the trustees exercised their discretion to make a lump sum payment.

16. Rev. Rul. 61-157, 1961 INT. REV. BULL. No. 35, Pt. 5(d).

17. Various provisions for vesting are in use, some providing for vesting faster than the ten-year example used in the text, and some providing for no vesting at all until attainment of retirement age or death prior to attainment of retirement age. A determination as to what constitutes a satisfactory vesting provision will depend upon the facts of a particular case. In all events, the length of the vesting period must not be such that it will result in discrimination in favor of employees who are officers, shareholders, supervisory employees, or highly paid employees. Also, when an employee reaches normal retirement age or has satisfied any reasonable requirement as to length of service or participation, his interest in the plan must vest. Furthermore, at such time as the plan terminates, all employees then covered by the plan must have their interests vested, and all funds must then be distributed in a non-discriminatory manner. Rev. Rul. 61-157, *supra*, Pt. 5(c).

terminate his employment at that time. The remaining 700 dollars would be allocated to those employees still under the plan, in the case of profit sharing, or would be applied to reduce the subsequent year's contribution to the plan by the employer if a pension plan were in effect.

Vesting provisions can be drafted by which an employee could have all of his vested rights forfeited if he were to leave the employer and subsequently engage in competition with the employer, or if he were discharged by his employer for cause.[18] In the example above, if a forfeiture provision were in effect, the employee who is 30 percent vested and who either competes with his employer, or who is discharged for cause, would not be entitled to receive the 300 dollars of his vested interest.

After a plan is established, new employees coming into the organization who meet the eligibility requirements must be given an opportunity to participate in the plan.[19] Hence, at any particular time, the number of participants may be larger, or smaller, should persons sever their employment, than at the plan's inception.

Under the provisions of the Internal Revenue Code, a plan will be considered qualified if it is established and administered for the exclusive benefit of the employees and their beneficiaries, so that it would be impossible for the funds of the plan to be returned to the employer or otherwise diverted for the benefit of the employer prior to the satisfaction of all liabilities to employees under the plan. In addition, no discrimination may occur under the plan which would favor the officers, stockholders, supervisory employees, or the highly compensated employees.[20] The manner in which these requirements are generally met is more fully discussed below.

Tax Advantages of Qualified Plans

The major tax advantages flowing from the qualified status of pension and profit-sharing plans may be summarized briefly as follows:

(1) The employer may deduct the amount of the contributions to the plan in the year when they are irrevocably contributed to the trustees.[21]

18. Rev. Rul. 61-157, 1961 INT. REV. BULL. No. 35, Pt. 5(c).

19. It is possibile to provide for one set of eligibility requirements for employees presently covered by the plan and a different set of eligibility requirements for future employees who may become eligible in later years, provided, however, that present employees who are officers, shareholders, supervisors, or highly compensated employees can meet the requirements provided for the new employees. Rev. Rul. 61-157, 1961 INT. REV. BULL. No. 35, Pt. 4(e).

20. See the authorities mentioned in note 5, *supra*. In addition, the trust instrument must specifically provide that none of the trust corpus or income may be diverted for purposes other than the exclusive benefit of employees or their beneficiaries. Furthermore, the trust must be created or organized in the United States. Treas. Reg. § 1.401-1(a)(3).

21. INT. REV. CODE OF 1954, § 404. For an exception, relating to accrual basis taxpayers, see below.

(2) The earnings of the assets of the plan are completely tax free, as long as these assets continue to be part of the pension or profit-sharing trust.[22] Thus, if the trustees of the plan buy a marketable security which yields a 5 percent return, the entire 5 percent earnings will be free of tax. Then these earnings will be compounded and are available for reinvestment in future years by the trustees, except to the extent of a distribution of funds to beneficiaries.

(3) An employee covered by the plan will receive long-term capital gain treatment for total distributions of the amounts held in his account made by the trustees to him, if he receives these funds in one taxable year at his retirement or severance of employment; and, if his beneficiaries receive a total distribution from the plan within one taxable year by reason of his death, whether before or after retirement, they, too, will have a long-term capital gain.[23] As an alternative, if the amount set aside in the employee's account is not taken out within one taxable year (the employee's or beneficiary's), but is received in installments over a period of years or as an annuity, then the tax rules applicable to annuities, under which a portion of the amounts received are treated as ordinary income, will apply.[24] Thus, an opportunity exists for treating the amounts accumulated tax free in the plan to be taxed to the employee at death or retirement or severance of employment, whichever is applicable, either at capital gains rates or as ordinary income spread over a period of years. In all cases, an employee does not receive any taxable income at the time the employer makes a contribution to the plan, and the trustees allocate the employee's share of the contribution to his account. The only time the employee pays any tax is when he receives the distribution from the trustees, and that tax may be a capital gains tax.[25] If an employee receives disability payments prior to re-

22. INT. REV. CODE OF 1954, § 501. For an exception, relating to unrelated business income, see INT. REV. CODE OF 1954, § 504.

23. INT. REV. CODE OF 1954, §§ 402(a)(2) and 403(a)(2). If the employee receives distribution of an annuity contract upon his separation from service, and if he surrenders it during the same taxable year for its cash value, he is entitled to treat the proceeds as a severance distribution, taxable as a capital gain. Rev. Rul. 55-298, 1955-1 CUM. BULL. 394.

The capital gains provisions do not apply to an employee who has retired, received several annual distributions taxable at ordinary income rates under the annuity rules (see *infra*), and then receives the entire balance remaining to his credit in one year. Treas. Reg. § 1.402(a)-1(a)(6)(iii). However, a lump sum paid to a death beneficiary is entitled to capital gains treatment although the employee had previously received some annuity payments after his retirement, but prior to his death. Treas. Reg. § 1.402(a)-1(a)(6)(ii).

For the capital gains provision to apply, an employee must completely sever his employment with the employer. Thus, a lump sum distribution does not qualify where the employee continues to act as an officer and director, even though his services are not substantial and he receives no compensation. Rev. Rul. 57, 1957-115 CUM. BULL. 160.

24. INT. REV. CODE OF 1954, §§ 402(a)(1) and 403(a)(1).

25. Treas. Reg. § 1.402(a)-1(a)(1)(i). But see *infra* p. 150, for an exception to this rule concerning life insurance premiums.

tirement, the payments are tax exempt to the extent of 100 dollars per week, and any excess is fully taxable.[26]

(4) Where amounts are paid by reason of the death of the employee, 5,000 dollars of the amounts received qualify for exclusion from income tax to the beneficiaries of the employee.[27] Other amounts received are taxable at capital gains rates if the funds are removed from the plan within one taxable year of the beneficiary, or otherwise at ordinary income rates under annuity rules.

(5) An employee covered under the plan may irrevocably designate his beneficiary for the death benefits to be provided by the plan, without incurring any gift tax as a result of this action.[28]

(6) The amounts received from the plan by reason of the death of an employee are fully excludable from the employee's gross estate under the federal estate tax rules, as long as the employee himself did not contribute any of his own funds to the plan and these amounts are not paid to his estate.[29]

(7) The treatment of life insurance benefits under qualified plans deserves special discussion, both from the standpoint of the employee and of his beneficiary. Where a qualified plan purchases a contract providing life insurance protection on the life of an employee, the life insurance cost is taxed currently to the employee if either the proceeds are payable to the employee's beneficiary or the proceeds are payable to the trust and the trustee is required to pay all of the proceeds to such beneficiary.[30] The amount of the current life insurance protection which is taxed currently to the employee is deemed to be the difference between the cash value of the policy at the end of a particular year and the amount payable at death at any time during the year. Ordinarly, this amount would be the difference between the surrender value and the face value of the policy. The cost of this life insurance, which is taxable to the employee currently, is the one-year term cost as determined by the particular insurance company, but not less than the amount set forth in the Rulings governing qualified plans.[31] The tax incurred by the employee under these circumstances would be at ordinary income rates.

When the insured employee dies prior to reaching retirement age, his beneficiaries will be entitled to receive the insurance proceeds on his life

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26. Treas. Reg. § 1.72-15(d).
27. Treas. Reg. § 101-2(b).
28. INT. REV. CODE OF 1954, § 2517.
29. INT. REV. CODE OF 1954, § 2039.
30. Treas. Reg. § 1.402(a)-1(a)(3)(i). The justification for this rule is that pure life insurance is considered a current benefit rather than deferred compensation.
31. Rev. Rul. 55-747, 1955-2 CUM. BULL. 228. The amount of this life insurance cost is set at relatively low rates in this ruling.

taken out through the plan. These insurance proceeds are divided into two elements for tax purposes. The first element is the cash value of the policy as it existed immediately prior to the death of the employee. The second element is the balance of the death proceeds. The cash value of the policy immediately before the death of the employee is not considered to be life insurance, which is generally exempt from all income taxes. Rather, the amount of the cash value is considered to be a part of the non-insurance investment portion of the plan and is taxed to the employee's beneficiary either as a capital gain, if all of the death benefits are distributed by the trustees within one taxable year of the beneficiary, or otherwise at ordinary income rates.[32] However, the 5,000 dollar income tax exclusion for death benefits described below will apply to reduce the amount taxable to the beneficiary.[33] The difference between the cash value and the total death proceeds of the policy is considered to be life insurance, and this amount is received by the beneficiaries of the employee entirely free of all income taxes. As stated above, the total amounts distributed by the qualified plan, whether considered to be insurance or not, are wholly exempt from estate taxes, so long as they are not paid to his estate and the employee did not contribute any of his own assets to the funding of these benefits. If an insurance contract is distributed to an employee upon his retirement from the employer, the entire cash value is treated as a cash distribution. However, he may postpone the realization of such income if he converts the cash value into an annuity contract within 60 days of the distribution.[34]

(8) Further significant rules apply to the distribution by a qualified plan of annuity contracts purchased by the trustees, with or without life insurance protection, on the life of an employee. Where such a plan distributes an annuity contract that does not provide any life insurance protection, the employee is not subject to tax by reason of the receipt of the contract, unless and until the contract is surrendered.[35]

The operation of these tax characteristics is quite varied and will have a different significance in each particular situation. Some of the important factors which are operative will become manifest in the following discussion.

Employee Benefits

The primary benefit which an employee receives from a qualified plan is the financial security of having an amount set aside for him each year. This amount, combined with Social Security, can be the foundation for

32. Treas. Reg. § 1.402(a)-1(a)(4).
33. The taxable amount would also be reduced by the amount of any premiums previously taxed to the employee on this life insurance coverage. Treas. Reg. § 1.402(a)-1(a)(4)(iii).
34. Treas. Reg. § 1.402(a)-1(a)(2).
35. *Ibid.*

a comfortable and more secure retirement after the employee's productive period has ceased. This arrangement also assures, through the prompt retirement of aged employees, promotion opportunities for younger deserving personnel. In addition, the plan provides an opportunity for the accumulation of retirement funds for the employee leaving his current earnings intact. For this reason, the amounts contributed to the plan increase his spendable income because he need not set aside funds for his retirement or create an estate for his family in the event of his death.

The fact that the contributions when made by the employer to the plan are not taxed to an employee until such time as they are received upon his retirement, by severance of employment, or by his beneficiary in the event of his death, creates a great deal of investment leverage operating in his favor. If the employee himself were to set aside a certain amount each year, it would have to be the amount which is left after he pays the applicable income taxes. Furthermore, as this amount earns money each year, he will have to pay a tax on the earnings, leaving him a smaller amount to reinvest. On the other hand, funds set aside in the plan are derived from pre-tax dollars, and the earnings can be accumulated without any diminution as a result of income taxes.

To illustrate the principle under discussion, assume that an executive covered by a qualified plan has the opportunity to take 1,000 dollars as an increase in his salary on which he will have to pay an ordinary income tax, or to receive the benefits of a qualified plan and have a contribution of 1,000 dollars therein for his own account. Also assume that the executive is married, files a joint return, has a taxable income of 15,000 dollars, and that his tax bracket will remain the same in subsequent years. The table below shows the tax impact of following two courses of action—receiving 1,000 dollars in salary without a plan or having 1,000 dollars contributed to a plan.

	Without a Plan	With a Plan
Balance of 1,000 dollars *after tax*	$700	$1,000
After tax yield on 3 per cent	2.1%	3%
Investment result after 20 years	$17,500	$27,700

From this table it can be seen that 27,700 dollars would be accumulated under the use of a qualified plan, with an annual contribution of 1,000 dollars. On the other hand, only 17,500 dollars would be accumulated by the private efforts of the executive in question. The 27,700 dollars accumulated under the plan could be removed by the executive at his retirement, at capital gains rates, which would yield him a net investment recovery of 23,545 dollars, after the payment of all taxes, as compared to the 17,500 dollars accumulated by his own private efforts without a plan. Thus, the overall tax benefit in the example given above is 6,045 dollars, or more than 33 1/3 percent better investment results than could be obtained without a plan. Furthermore, if the employee died before retirement, the amount of benefits passing to his estate would be entirely free of estate tax, whereas the 17,500 dollars which he accumulated through his own private efforts would be includable in his taxable estate for federal estate tax purposes, and that amount would have to be reduced by the appropriate estate tax attributable thereto.

The question then arises as to which employees should be eligible to participate in the plan. As stated above, the Internal Revenue Code requires that regardless of which employees are covered, the classification of those participating in the plan should not discriminate in favor of the employer's officers, stockholders, supervisory employees, or highly compensated employees. As long as the prohibited discrimination does not result, any reasonable classification of employees may be designated to participate under the plan. The Internal Revenue Code sets forth a specific mathematical employee coverage test which is deemed not to discriminate in favor of the proscribed group.[36] If this test is met, there is no discrimination. If this test is not met, however, the Internal Revenue Service has the right to investigate the classifications established to see that no discrimination will result in the operation of the plan. The failure to meet the mathematical test has the significance of requiring the employer to demonstrate that the classification used is satisfactory.[37] An advantage of meeting the mathematical formula is the automatic acceptance of the classification used.

The application of the mathematical test is as follows: employees who have been employed for less than five years, or such other lesser minimum period as may be provided for in the plan, and employees whose customary employment is for not more than twenty hours a week or for not more than five months a year, may be excluded. Taking the remaining employees, the plan must cover either 70 percent of those employees remaining, or 80 percent of the eligible employees, provided that 70 percent or more of the remaining employees are eligible to participate in the plan. For example, a company with 100 employees adopts a pension plan which provides coverage for all employees who have been employed five years. Forty of the employees have been employed for less than five years. This leaves 60 employees to which the test is to be applied. If the plan covers 42 employees (70 percent of 60), it will qualify under the mathematical test. Assume further that it is a plan under which employee contributions are required. If 34 employees would like to participate (80 percent of the 42 who are eligible), the plan will qualify.

36. INT. REV. CODE OF 1954, § 401(a)3.
37. Treas. Reg. § 1.401-3(b).

Even though the plan fails to meet this mathematical test, it may still qualify as to coverage if it sets up a coverage classification that is found by the Internal Revenue Service not to effect the prohibited discrimination in favor of key employees. The Internal Revenue Code further provides that a classification other than the mathematical test used above will not be considered discriminatory merely because it excludes employees who receive compensation of less than 4,800 dollars a year (the maximum amount constituting wages under the Social Security Act currently in effect), or merely because coverage is limited to salaried or clerical employees.[38] This means that employee classifications which include only salaried or clerical employees, or which automatically exclude those employees earning less than 4,800 dollars a year, will not by virtue of that fact alone be considered to be discriminatory. On the other hand, such classifications are no assurance that the plan will qualify, since the Internal Revenue Service will still investigate the employee classification used to determine whether the proscribed discrimination exists even under those circumstances.

Although each case will be different, experience has indicated that there is great flexibility in determining what constitutes the proper classification of employees to come under the plan. In general, a representative portion of the low-paid employees must be included, along with shareholder-executives, key personnel, and other highly paid employees. Classifications such as those limited to male salaried employees have been found to be acceptable under various circumstances by the Internal Revenue Service. Under other situations, employees who have not attained thirty years of age can be excluded. Whether a classification is found reasonable is a question which is subject to discussion with the Internal Revenue Service in each particular case. However, it can be safely said that great flexibility is permitted in establishing employee categories for participation in the plan.

As respects excluding from coverage those employees earning 4,800 dollars a year or less, or, alternatively, excluding the first 4,800 dollars of each employee's annual wages, definite rules have been established. The Internal Revenue Service will permit the qualification of plans which supplement old-age benefits under the Social Security Act. Thus, a plan which excludes employees making 4,800 dollars or less a year, or which gives higher benefits on the basis of pay in excess of 4,800 dollars, is required to be "integrated with Social Security."[39] A plan which results in relatively or proportionately greater benefits to employees earning above any specified amount of compensation may be found to be discriminatory unless the differences in benefit are approximately offset by the Social Security benefits. To determine whether

38. INT. REV. CODE OF 1954, § 401(a)(5).
39. Treas. Reg. § 1.401-3(e).

the plan is properly "integrated" is often a very complex matter and beyond the scope of this article. However, under certain conditions, relatively higher benefits can be obtained for the more highly compensated employees by the total or partial exclusion of lower-paid employees through the process of integration.

It should be noted that only "employees" can be covered by a pension or profit-sharing plan. In a "close corporation," the shareholders, who own the business, are most often the key employees conducting the business. They can qualify for participation in the plan and enjoy all of the benefits which are appropriate.[40] However, a business that is conducted as a partnership or as a proprietorship represents a different matter. In the eyes of the law, neither a partner nor a proprietor are considered to be employees.[41] Thus, in considering whether the owner of a particular business can qualify for eligibility in the plan, unless the business is conducted as a corporation, the owner will not be permitted to participate. In order to obtain the benefits of membership in such a plan, either incorporation of the business or compliance with section 7701 of the Code (and regulations thereunder) is required. Whether this would be advantageous under a particular set of circumstances cannot be determined in advance, but the decision must rest upon a consideration of all the factors inherent in the process of incorporation.

The Difference Between Pension and Profit Sharing

The two types of plans under consideration in this article are pension plans and profit-sharing plans, each of which has different underlying assumptions, and is administered somewhat differently. The theory behind the profit-sharing plan is that it is merely a "pot" into which a share of the employer's profits is placed each year, to be distributed to employees at a later date, such as at retirement age.[42] The maximum amount of profits which can be deducted in any one year is an amount equal to 15 percent of the applicable compensation of those employees participating in the plan.[43] This is the maximum amount only. The amount actually contributed each year can be left to the employer's complete discretion. If, in any year, more than 15 percent is contributed, a carry-forward to a subsequent year of the unused portion of the contribution is permissible to the extent that the contribution for such succeeding year is less than the allowable 15 percent.[44] Furthermore, the employer can make an additional contribution in the succeeding year to make up any amount less

40. Treas. Reg. § 1.401-1(b)(3).
41. Rev. Rul. 61-157, INT. REV. BULL. No. 35, Pt. 2(e).
42. Treas. Reg. § 1.401-1(b)(1).
43. INT. REV. CODE OF 1954, § 404(a)(3)(A). The 15 percent computation does not take into account any contributions made to the plan. It is based solely on compensation other than deferred compensation.
44. Treas. Reg. § 1.404(a)-9.

than 15 percent contributed in a prior year.[45] However, the total of all these deductions may not exceed an aggregate of 30 percent in any one year. The only condition which the Internal Revenue Service requires is that the plan contributions be substantial and recurring.[46] Contributions cannot be discontinued or minimized on any indefinite basis. However, if in any year there are no profits, then there is no obligation to contribute any amount to the plan.

Once contributions are made to the profit-sharing plan, they are then allocated among all employees in proportion to their applicable compensation or in proportion to a factor which is a combination of each employee's applicable compensation and his years of service with the employer.[47]

Thus, an illustration of a simple profit-sharing situation would be to assume that the plan covers five employees—*A*, *B*, *C*, *D*, and *E*. *A*'s compensation is 30,000 dollars a year; *B*'s is 25,000 dollars; *C*'s, 20,000 dollars; *D*'s, 15,000 dollars; and *E*'s, 10,000 dollars. Accordingly, their total compensation is 100,000 dollars. Further assume that a profit-sharing contribution of 10,000 dollars is made on their behalf. This amount would be allocated between the employees, based on the ratio which each employee's salary bears to the total salary, as per the following schedule:

		Allocation to the Employee Accounts	
Employee	Annual Salary	Percent	Amount
A	$30,000	30%	$3000
B	25,000	25	2500
C	20,000	20	2000
D	15,000	15	1500
E	10,000	10	1000
Total	$100,000	100%	$10,000

The amount available to these employees at their retirement is contingent upon the profits of the employer and the percentage of these profits which the employer is willing, in his discretion, to continue to contribute to the plan. Likewise, the amount in the fund at retirement date is also dependent upon the earnings of the trust from the investments made with the contributions to the plan. Whatever this fund totals for each employee as he reaches his retirement age, or at his death, or at the severance of his employment, is what his benefits will be. There is no predetermined amount which the employee will be entitled to receive upon any of these events.

A pension plan, however, is quite different.[48] Once it is understood, its

45. INT. REV. CODE OF 1954, § 404(a)(3)(A).
46. Rev. Rul. 61-157, INT. REV. BULL. No. 35, Pt. 2(p).
47. Treas. Reg. § 1.401-1(b)(ii).
48. The Regulations define a pension plan as one established for the payment of definitely determinable benefits for employees over a period of years, usually for life,

flexibility and uses become apparent. The most commonly employed type of pension plan is one in which the pension to be provided is expressed as a percentage of an employee's annual salary, or as a percentage of his salary multiplied by a "years of service" factor. This "years of service" factor may include all or a part of the employee's past service prior to the adoption of the plan, as well as his anticipated future service in later years. An illustration of the former arrangement would be a pension equal to 25 percent of an employee's annual salary. This means that a participant earning 10,000 dollars would be entitled to an annual retirement pension of 2,500 dollars, beginning at age 65. The second arrangement might be exemplified by a pension formula based upon one percent of salary for each year of past service with the employer. In this latter case, an employee earning an annual salary of 10,000 dollars with fifteen years of service would be entitled to an annual retirement pension of 1,500 dollars. Thus, the more commonly employed type of pension plan differs from the profit-sharing plan in that the benefit—the pension—is fixed. In a profit-sharing plan, the pension is not fixed, but is whatever amount has accumulated in the employee's account at such time as the employee retires, becomes deceased, or otherwise qualifies for benefits.

Once the amount of pension benefit is established for each employee, the cost of providing these benefits must be determined. There is a wide latitude permitted in making this determination. The best manner of explanation is to proceed with a concrete example. At the risk of oversimplification, assume that *X* is an employee covered by a pension plan, is 45 years of age, and it is contemplated that he will have a pension of 1,000 dollars a month, payable over his lifetime, or for ten years certain, exclusive of any Social Security benefits to which he would be entitled when he attains age 65. Since *X* is to have a pension of 1,000 dollars a month at age 65, then during the twenty-year period from age 45 until he attains age 65, an amount will have to be contributed to the plan each year which will at the end of twenty years equal an amount sufficient to produce the principal and income to fund the desired pension. Various factors enter into the computation of the annual contribution necessary in this case.[49] Among these are the amount of earnings which each year's contribution will produce while held by the trust (the interest factor), the fact that certain employees will die before reaching age 65 (mortality factor), the fact that certain employees will leave their employment prior to reaching age 65 (turnover factor), the

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after retirement. The determination of the retirement benefits and the contributions to provide these benefits do not depend upon the employer's profits, but can be measured actuarially. Treas. Reg. § 1.401-1(b)(i).

49. The actuarial factors mentioned in this paragraph are discussed in Treas. Reg. § 1.404(a)-3(b).

amount of life insurance protection to be provided and the cost of these premiums, the reasonable costs of administering the plan, the fact that certain employees will reach age 65, retire, and then either will die soon thereafter, or alternatively, live to a ripe old age. How these factors are to be measured depends upon the assumptions to be used in each case. Their application in any particular instance is a matter which only a qualified actuary can determine. In any event, there is a wide latitude in choosing the applicable factors to be utilized, and the choice of each factor will materially affect the cost of the plan and the amount allocated to each employee's account.

Returning to *X*'s example, the application of a very simple set of actuarial assumptions indicates that the amount necessary to be provided by the plan for *X* at age 65 is 158,800 dollars. An annual contribution of 4,359 dollars will suffice to provide the pension required.[50] As the plan continues through the years, adjustments may have to be made on account of any experience in mortality, interest, turnover, and similar items, which is more favorable than that assumed at the inception of the plan.[51]

Because computation of the amount necessary to be contributed annually to provide *X* with the desired pension is an actuarial matter, the permissible annual deduction which the Internal Revenue Code allows for a pension plan is also based in large part upon actuarial factors.[52] Since there is a wide

50. Based upon Commissioner's Standard Ordinary 3% Mortality Table.

51. Rev. Rul. 59-153, 1959-1 CUM. BULL. 89.

52. INT. REV. CODE OF 1954, § 404, in conjunction with INT. REV. CODE OF 1954, § 162, controls the permissible deduction allowed to qualified pension plans. To be allowable deductions, contributions to a plan must be ordinary and necessary business expenses, reasonable in amount, and the contribution made on behalf of each participant, when added to the other compensation payable to such participant, must not exceed a reasonable amount of compensation for the services rendered by such participant. This does not mean that the contribution plus the other compensation for the participant for the current year cannot exceed a reasonable compensation allowance. Rather, it means that the reasonable compensation test will be met if all compensation and all contributions paid to or on behalf of the participant in both prior years and the current year do not exceed a reasonable allowance for the services rendered by the participant over the prior years and up to the end of the current year. Treas. Reg. § 1.404(a)-1(b).

Assuming that the requirements of § 162 are met, as discussed in the above paragraph, § 404(a)(1) provides three alternative methods of computing the maximum deductions for a pension plan. These are known as the "Clause A," "Clause B," and "Clause C" methods, based upon the lettering scheme of this subparagraph of the statute.

Clause A permits deductions up to as much as 5 percent of the compensation paid during the year to all employees participating in the plan.

Clause B permits the deduction of the excess of the amount allowable under Clause A by providing that the amount of such excess which represents the remaining unfunded cost of the participants' past and current service credits shall be distributed as a level amount, or a level percentage, of compensation over the remaining future service of each participant. If the amount of such remaining unfunded costs for any three individuals is more than 50 percent of the unfunded costs for all participants, the costs attributable to these three individuals must be spread over at least five taxable years.

Clause C represents a method of computing the deduction in lieu of the methods set latitude of judgment in applying these various actuarial factors, a similar latitude of judgment extends to the amount of the permissible deduction. In many cases it is possible with a pension plan to contribute a much larger amount than would be possible under a profit-sharing plan, which has its 15 percent of applicable compensation as a limiting factor on the amount to be contributed each year.

The Problem of the Fixed Contribution

The question often arises as to whether the establishment of a qualified plan results in a fixed commitment upon the employer, which he must meet in bad times as well as good times, whether there are profits or whether there are losses in the business, and whether his cash position will permit a contribution or not. It is generally assumed that a pension plan is a fixed commitment, while a profit-sharing plan largely escapes the idea of fixity of contribution. To a limited extent, a profit-sharing plan is more flexible than a pension plan, since there need be no fixed percentage and no liability to make a contribution in the absence of profits. Nevertheless, as a practical matter, in operation both types of plans tend to be similar. Even with the profit-sharing plan, once it is announced to the employees and a contribution made, the employees usually come to expect a similar contribution to be made each year. Also, when profits increase, the employees expect an increased share in the form of an increased profit-sharing plan contribution. Accordingly, even with a completely discretionary profit-sharing plan, it is morally difficult and possibly disadvantageous from a labor relationship standpoint for an employer to ignore these expectations and diminish profit-sharing contributions or skip them altogether in any one year. In many ways a profit-sharing plan contribution in the eyes of the employees is similar to a Christmas or year-end bonus. Giving such bonuses is purely discretionary with the employer, but once they are given, it is extremely difficult not to repeat them in subsequent years. To this extent, even a completely discretionary profit-sharing plan resembles a pension plan which requires an actuarially determined amount to be contributed each year.

On the other hand, a pension plan may have its fixed annual contribu-

forth in Clauses A and B. This deduction is the amount of the "normal cost" of the plan for the current year, plus 10 percent of the cost of the past service liability, if any, which the plan provides, until such time as these past service liabilities are fully funded. The normal cost for any one year is the amount, actuarially determined, which would be required as a contribution if the plan had been in effect from the beginning of service of each employee covered by the plan, assuming that all costs attributable to prior years' services had been paid for and that all assumptions as to interest, mortality, etc., had been fulfilled. Past service costs are the costs, actuarially determined, required to meet all future benefits provided by the plan which are not covered by future normal costs and employee contributions. Treas. Reg. § 1.404(a)-6(a)(2).

§ 404(a)(1)(D) provides a carry-over for excess contributions made by an employer in prior years.

tion modified under certain circumstances. In any particular year, especially when the employer is short of cash, the contribution to the pension plan can be made either by a promissory note of the employer, or by a cash contribution and then borrowing the money back from the plan.[53] There are definite rules and regulations surrounding contributions of promissory notes to the pension plan, but if these rules are observed scrupulously, and if the promissory note is paid within a reasonable period of time, this procedure can be followed with relative safety. The law requires that the promissory note be adequately secured and bear a reasonable rate of interest. The Regulations describe what those terms mean in considerable detail.[54] Bear in

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53. When an employer contributes its promissory note to a qualified plan, two questions arise. First, is the note a "payment" of the contribution on which a deduction can be based? Second, is the holding of an employer's note by the plan trustees a "prohibited transaction," which the Internal Revenue Service will attack and by which it will attempt to disqualify the plan?

On the issue of "payment," some doubt exists as to whether the mere delivery of an employer's promissory note is sufficient. The Tax Court has held that a note is not payment, under the provisions of § 404, even where the employer is solvent and the note is subsequently paid. Time Oil Co., 26 T. C. 1061 (1956), *rev'd*, 258 F.2d 237 (9th Cir. 1958); Slaymaker Lock Co., 18 T. C. 1001 (1952), *rev'd*, 208 F.2d 313 (3d Cir. 1953); Freer Motor Transfer Co., 8 T. C. M. 507 (1949). On the other hand, both the Third and Ninth Circuits have reversed the Tax Court on this issue. Time Oil Co., *supra*; Slaymaker Lock Co., *supra*. Because of this confusion, it would be more advisable for an employer to make the contribution in cash, and subsequently borrow back the funds from the plan, giving his note as collateral. This would indicate a clear payment of the contribution, and would only raise the further question of whether the borrowing was a prohibited transaction.

Prohibited transactions are defined in § 503(c) to include a loan from a qualified pension or profit-sharing trust to the employer-grantor without adequate security or reasonable interest rates. Thus, if the employer's note is contributed to the plan, or if the employer later borrows money, this question arises. Full disclosure of the circumstances surrounding these loans must be made to the Internal Revenue Service. Treas. Reg. § 1.401-1(b)(5). Adequate security is defined as,

> something in addition to and supporting a promise to pay, which . . . may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, . . . and . . . which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan. Mortgages or liens on property, accommodation endorsements of those financially capable of meeting the indebtedness, and stock or securities issued by corporations other than the borrower, may constitute security. . . .

Treas. Reg. § 1.503(c)-1(b)(1). The examples set forth in this portion of the Regulations make it clear that a promissory note of a corporate employer, endorsed by a party of sufficient financial responsibility will be considered adequate security. It may be that, depending upon the circumstances involved, the endorsement of the corporate shareholders in their individual capacities may of itself be adequate security. See also note 54, *infra*.

54. See note 53, *supra*. There are three exceptions to the requirement that a note must be secured. A qualified plan of a subsidiary corporation may invest funds in the unsecured debentures of the parent corporation. This is not a prohibited transaction, since the parent is not the grantor of the trust nor a corporation controlled by the grantor. Rev. Rul. 58-526, 1958-2 CUM. BULL. 269. In addition, the Technical Amendments Act of 1958 added detailed provisions to the Code whereby qualified plans could acquire unsecured debentures. These provisions are found in INT. REV. CODE OF 1954, §§ 503(h) and (i). An unsecured obligation may be acquired by the trust if:

mind, however, that the contribution of a promissory note to a pension plan or borrowing from the plan cannot be done for an unlimited number of years. These notes constitute a true indebtedness and they must eventually be liquidated; otherwise, it is quite likely that the Internal Revenue Service would object to this manner of making contributions, and the deductions for the plan would either be disallowed or the entire plan would be in danger of losing its qualified status.[55]

In addition, if it should appear desirable, the benefits provided by the plan can be reduced, so that each employee covered under the plan would be entitled to receive a smaller pension than previously was the case. This would have the effect of reducing the cost of the plan, and contributions could be thereby lessened. This is called "curtailment" of a plan. Likewise, a plan can be completely terminated, under certain circumstances, and also contributions can be suspended for a year or for a period of years. In the case of a curtailment or a termination of a plan or a suspension of contributions, the Internal Revenue Service will examine these events closely. These actions can be taken only when there is a business necessity which dictates the need for the curtailing, terminating, or suspension of contributions to the plan.[56]

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(1) The trust does not acquire more than 25 percent of all the obligations issued by the employer.
(2) Fifty percent of the obligations issued are held by persons independent of the issuer.
(3) More than 25 percent of the trust's assets are not invested in these obligations.
(4) The price at which the obligations are acquired must be that prevailing on a securities exchange. If the obligations are not traded on a securities exchange, the price of the acquisition must be no greater than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer.

The third exception relates to employers' obligations where a reasonable rate of interest is provided for and the following conditions are also met, pursuant to § 503(i):

(1) The employer is prohibited from pledging as security a particular class or classes of assets, the value of which is more than 50 per cent of the value of all of the employer's assets, by any law or regulation of the United States.
(2) The loan is approved in writing by an independent trustee as consistent with the exempt purposes of the trust, and no other such trustee has previously refused to give such written approval.
(3) Immediately following the loan, the amount of the loan does not exceed 25 percent of the value of all the assets of the trust.

55. INT. REV. CODE OF 1954, § 503.

56. Mim. 6136, 1947-1 CUM. BULL. 58 (termination and curtailment); P. S. No. 57 (August 5, 1946) (suspension of contributions). In general, see Rev. Rul. 61-157, 1961 INT. REV. BULL. No. 35, Pts. 2(p), 5(a) and (f) and Goodman, *Permanency as a Requisite of Tax Qualified Pension and Profit-Sharing Plans*, 39 TAXES 42 (Jan. 1961).

Upon termination, curtailment, or suspension, the Internal Revenue Service may either conclude that the plan is totally disqualified, which may require the loss of the employer's deduction for all or a portion of the plan contributions in prior years, and the employees will have realized current income at the time of each past contribution, or the Service may conclude that the termination, curtailment, or suspension is permissible without any penalty being attached to these actions. Treas. Reg. § 1.401-1(b)(2). Where contributions are suspended, the question is whether in reality a permanent discontinuance of contributions has occurred. This is a question of fact, dependent on all of the

The answer to whether the Internal Revenue Service will consider a particular set of circumstances as constituting the requisite business necessity may be obtained by an advanced ruling. The Government's approach in this area is a reasonable one, and if the business necessity truly is present, the termination, suspension, or curtailment should be permitted. Thus, it has been ruled that a corporation could terminate its plan where new salary increases plus pension contributions would have created a substantial net loss.[57] Likewise, a plan may be terminated where the business is sold, and new owners take over the business.[58] Termination is also permissible when a corporation is liquidated,[59] when the employer is in severe financial difficulties,[60] and where the plan is terminated because the employees favored a cash bonus program rather than deferred compensation.[61] In this fashion, a pension plan can become somewhat more flexible in the event that circumstances make continued contributions undesirable as a matter of business necessity.

Many times a contribution to the pension plan can be reduced because of more favorable actuarial experience than was assumed at the inception of the plan with respect to mortality, interest, turnover, or other similar factors.[62] When the plan is re-examined actuarially, future contributions may be reduced if the experience preceding the re-evaluation was more favorable than that assumed at the inception of the plan.

It might be well to note at this point the application of a rule which affects pension plans but not profit-sharing plans. This is the so-called "ten-year termination" rule which is designed to avoid the following type of discrimination in favor of shareholder-executives and other proscribed groups:

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surrounding circumstances. If it is a permanent discontinuance, then the rules on termination apply. If it is not, then employees' interest need not vest at the time of the suspension, nor will the plan lose its qualified status so long as the benefits provided by the plan are not affected and the unfunded past service costs do not exceed the amount of such costs as of the date of the establishment of the plan. Rev. Rul. 61-157, 1961 INT. REV. BULL. No. 35, Pt. 5(f). An advance ruling on this situation can be obtained from the Service. Rev. Rul. 61-157, 1961 INT. REV. BULL. No. 35, Pt. 2(p).

A curtailment is treated as a partial termination and the same rules apply to either case. Mim. 6136, 1947-1 CUM. BULL. 58. Thus, upon a termination, curtailment, or a suspension of contributions equivalent to a permanent discontinuance, the plan does not lose its qualified status if business necessity for this action exists and if all employees' interests vest at that time. Mim. 6136, *supra*; Rev. Rul. 55-60, 1955-1 CUM. BULL. 37. Business necessity has been held to include the following events: merger, corporate dissolution, financial difficulties, sale of company, death of employer, lack of employee participation, and change to a cash bonus program, rather than one of deferred compensation. See the tabulation of favorable termination rulings issued by the Service from September 1 through November 25, 1957, as reproduced in Prentice-Hall, *Pension and Profit-Sharing*, ¶ 4213.

57. Mim. 6136, *supra* note 56.
58. *Ibid.*
59. Harold S. Davis Estate, 22 T. C. 807 (1954).
60. See note 56, *supra*.
61. Kane Chevrolet Co., 32 T. C. 596 (1959).
62. See note 51, *supra*.

in a certain situation, shareholder-executives and other favored employees may be older than the other employees covered by the plan, and accordingly are closer to retirement age than the other employees. If no restriction existed, it would be possible to make contributions to a plan to fully fund within a few years the benefits to be obtained by these older employees, and then to terminate the plan and have the favored groups retire with a fully funded pension. The result would be that the lower-paid employees, who are presumably younger, would not have fully funded benefits, but only a partial funding of their potential pensions. To avoid this potential discrimination, the "ten-year termination" rule was developed,[63] its limitations set forth fully in the Rulings governing pension plans. In general, the restrictions apply only during the first ten years of the plan, and with respect to benefits payable to the twenty-five highest-paid employees in the plan at its inception whose annual pension would exceed 1,500 dollars. So long as the plan is not terminated and its "full current costs" are met, these limitations usually will not restrict payment of full current benefits or death benefits to any employee who becomes entitled to them during the ten-year period. The term "full current costs" means normal costs for all years since the effective date of the plan, plus interest for such period on the unfunded liability. However, even if the plan is terminated during its first ten years and the ten-year termination rule applies, the limitations may not have any substantial effect. The ceilings on benefits to the proscribed group are relatively liberal, as they start with a minimum allowance limit to any one of the proscribed employees of 20,000 dollars, which can increase to a maximum of 100,000 dollars. Since these limitations generally apply only in the event of early plan termination, they are not a serious factor in formulating a pension plan, for an employer is generally willing to carry on a retirement program over and beyond any ten-year period.

As to the question whether a pension plan contains a more fixed commitment than a profit-sharing plan, the following conclusions seem reasonable:

(1) A profit-sharing plan is theoretically more flexible, but in practice it is much like a pension plan in that annual contributions will have to be made. In a profit-sharing plan, however, the necessity for continued contributions of similar amounts rests with the expectations raised in the minds of employees, rather than any specific legal requirement.

(2) More money can be contributed into a pension plan, since the 15 percent of applicable salary limitation applies only to profit-sharing plans.

(3) Within certain limitations, and for limited periods of time, a pen-

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63. Mim. 5717, 1944 CUM. BULL. 321.

sion plan can be made flexible to a degree which approximates that of a profit-sharing plan.

In all cases, the proper choice to be made between pension or profit-sharing plans is one dependent upon all the facts of a particular case. It would be advisable in all situations to prepare computations indicating the effect of both types of plans upon employees to be covered by the plan, as well as their effect upon the employer in terms of cost. It is possible for an employer to have both a pension and a profit-sharing plan simultaneously. The only limitations are that both plans independently qualify as non-discriminatory plans and that no employee so covered has contributions on his behalf to both plans in excess of 25 percent of his applicable compensation.[64] It should also be noted that an employer can have two or more profit-sharing plans or two or more pension plans, so long as all the plans, when viewed as a whole, qualify as non-discriminatory under the standards applied by the Internal Revenue Service.[65]

Plan Investments

The plan can be drafted in such a way that the trustees are authorized to invest in any reasonable form of property. Stocks, bonds, real estate, mortgages, mutual funds, and similar investments can be utilized.

Qualified plans may invest in life insurance within certain limits. With respect to a profit-sharing plan, the aggregate premiums for insurance for each participant may not exceed 50 percent of the aggregate of the contributions and forfeitures allocated to him at any one time.[66] Under a pension plan, the amount which can be invested in life insurance is an amount which provides a death benefit no greater than 100 times the monthly pension provided under the plan.[67] The life insurance proceeds, as distinguished from the cash value existing prior to the death of that employee, when payable to the beneficiaries of the employee at his death, are totally free of income tax and may be free of estate taxes. The cash value portion of the policies may be treated as capital gain.[68]

Under certain circumstances, the trustees may lend to the employer some of the funds of the plan, provided that adequate safeguards are met.[69] For example, the regulations of the Internal Revenue Service provide that loans to an employer may be made if the loan is adequately secured and provides for a reasonable rate of interest. However, these transactions should be entered into with great caution. Should the safeguards not be met, the loan

64. INT. REV. CODE OF 1954, § 404 (a)(7).
65. Treas. Reg. § 1.401-3(f).
66. Rev. Rul. 61-157, 1961 INT. REV. BULL. No. 35, Pt. 2(d).
67. *Ibid.*
68. See notes 30-33, *supra*.
69. See notes 53, 54, *supra*.

might be considered a prohibited transaction, in which case there is grave danger that the pension plan may lose its qualified status.

Under specified circumstances, the plan may also invest in the stock or other securities issued by the employer. Here, too, as in the case of loans to an employer, special safeguards are imposed to assure that the funds of the plan are not used for the benefit of the employer, but are adequately safeguarded for the benefit of the employees.[70] Again, transactions of this type should be undertaken only with the greatest caution, and where obtainable, a ruling should be sought from the Internal Revenue Service.

Qualification Procedures

It is most desirable to secure a determination in advance from the Internal Revenue Service concerning whether a newly created plan qualifies for the various benefits provided in the Code.[71] But before so acting, certain definite steps should be taken to assure qualification. Employers generally wait until close to the end of their taxable year before taking clear-cut action on the plan which they have discussed and thought about for a long time. Too long a delay may result in losing the right to take a deduction for the first year of the plan. As a minimum, the following should be accomplished before the close of the taxable year:[72] the trust should be created, signed by all parties, and a small payment made to the trustees, in order that the trust may have some corpus before year end. The plan should be formally adopted and signed by all parties. The covered employees should be informed of the existence of the plan, its terms and provisions. This can be fulfilled either by making copies of the plan available, or by providing explanatory booklets summarizing the plan. At some time prior to the filing of the tax return for that year, the balance of the contribution should be paid to the trustees.[73] For profit-sharing plans an additional step must be taken if the plan is one where the employer has discretion as to the amount of the contribution. In this situation there must be a definite liability to make the contribution before the close of the taxable year.[74] Therefore, the directors of the corporate employer should adopt a resolution prior to the end of the year specifying the amount of the contribution. The failure to attend to any of these steps may result in a determination that the plan was not brought into existence during the taxable year.

When the plan is examined by the Pension Trust Section of the Internal

70. INT. REV. CODE OF 1954, § 503.

71. Treas. Reg. § 601.201(1); Rev. Proc. 56-12, 1956-1 CUM. BULL. 1029.

72. See Rev. Rul. 61-157, 1961 INT. REV. BULL. No. 35, Pt. 2(j) and (k).

73. For accrual basis taxpayers only, the deduction is permitted if payment is made to the trustees by the due date of the tax return, including any extensions granted for late filing. INT. REV. CODE OF 1954, § 404(a)(6).

74. Treas. Reg. § 1.404(a)-1(c).

Revenue Service, conferences may be held, at which point the Pension Trust Section will make clear its objections, if any, to the plan. Ample opportunity will then be given in most cases to the employer to amend or modify the plan in any respect in order to make it suitable for qualification. When the Government is satisfied that all requirements have been met, a determination letter, indicating that the plan is qualified, will be issued to the employer. If the plan does not qualify after negotiations with the Service have taken place, it is possible for the contributions made to the plan in the interim to be refunded to the employer and the plan terminated at that point.[75] In order to have these contributions refunded, a special provision to this effect must be inserted in the plan. After a plan has qualified, assuming that it operates in such a fashion that no discrimination results, it will continue to enjoy the benefits of qualified status for the full term of its existence.

Conclusion

With respect to pension and profit-sharing plans, flexibility is the keynote. There are many opportunities available to tailor the plan to the individual needs of a particular employer. There is much opportunity for exercising business judgment to assure oneself that maximum advantage is being taken of all opportunities.

Finally, it should be noted that a specific plan should be drafted upon the basis of decisions made as a result of qualified advice of one or more experienced advisors in the field. No "form" plan should ever be accepted. The drafting of a pension or profit-sharing plan and trust agreement constitutes the practice of law and should be undertaken only by a qualified attorney. The plan should be handled before the Internal Revenue Service by one who is qualified to practice before the Service and who is acting under the authority of a proper power of attorney.

When properly created and administered, the pension or profit-sharing plan represents an ideal method by which planning for an employee's retirement, or creating an estate for his family in the event of death, can become a substantial reality.

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75. Rev. Rul. 61-157, 1961 INT. REV. BULL. No. 35, Pt. 3(c).